U.S. Department of the Interior
Office of Inspector General

AUDIT REPORT

WORKING CAPITAL FUND, BUREAU OF RECLAMATION

REPORT NO. 96-I-644
MARCH 1996

United States Department of the Interior

OFFICE OF THE INSPECTOR GENERAL
Washington, D.C. 20240

MAR 29 1996

MEMORANDUM

TO: The Secretary

FROM: Wilma A. Lewis
Inspector General

SUBJECT SUMMARY: Final Audit Report for Your Information -"Working Capital Fund, Bureau of Reclamation" (No. 96-I-644)

Attached for your information is a copy of the subject final audit report.

We concluded that the Bureau of Reclamation had not fully complied with the legislation that established the Working Capital Fund in that the Fund was not fully recovering its costs and Fund management had not. established adequate procedures for controlling operational costs or identifying funds that may be surplus to verifiable Fund needs. In addition, the Fund's internal control structure did not provide reasonable assurance that transactions were recorded properly. As a result, depreciation costs of $25.3 million were not recovered; accrued annual leave of $9.7 million was not funded; and customers were overcharged $15.6 million for operational expenses. The Bureau concurred with four of our seven recommendations and has taken action to implement those four recommendations. However, the Bureau did not concur with our recommendations to require: (1) Working Capital Fund activities to establish billing rates that will recover full costs, including depreciation and accrued annual leave; (2) applicable activities of the Fund to return, to their customers through reduced future billings, the $15.6 million overrecovery; and (3) funds that were transferred to the Office of Aircraft Services, Office of the Secretary, to be taken from the Capital Reserves account. We have requested the Assistant Secretary for Water and Science to reconsider these recommendations.

If you have questions concerning this matter, please contact me or Ms. Judy Harrison, Assistant Inspector General for Audits, at (202) 208-5745.

Attachment

United States Department of the Interior

OFFICE OF THE INSPECTOR GENERAL
Washington, D.C. 20240

MAR 2 9 1996

AUDIT REPORT

Memorandum

To: Assistant Secretary for Water and Science

From: Judy Harrison Judy Harrison
Assistant Inspector General for Audits

Subject: Final Audit Report on the Working Capital Fund, Bureau of Reclamation (No. 96-I-644)

INTRODUCTION

This report presents the results of our audit of the Working Capital Fund. The objective of the audit was to determine whether: (1) the Fund was being operated in accordance with the United States Code, the Treasury Financial Manual, Office of Management and Budget Circulars and Bulletins, and Reclamation Instructions; (2) the Fund was being operated effectively and was fully recovering costs; and (3) the Fund's internal control structure provided reasonable assurance that transactions were properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets.

BACKGROUND

The Bureau's Working Capital Fund was established on December 3, 1985, by Public Law 99-141 (43 U.S.C. 1472). The objective of the Fund is to finance, in an efficient manner, support services and equipment for Bureau programs, other Federal entities, and non-Federal entities. The Fund is an intragovernmental revolving fund and, as such, is intended to operate entirely within its own resources rather than from an annual appropriation from the Congress.

Public Law 99-141 requires the Working Capital Fund to fully recover its costs, including depreciation and accrued annual leave. Furthermore, the Energy and Water Development Appropriation Bill of 1986 states:

> The Committee recommends bill language, the same that was included in the budget request, to establish a Working Capital Fund in order to help

> provide for more efficient financing and financial management of certain activities of the Bureau of Reclamation . . . . The Committee hopes that establishment of such funds would slightly reduce the annual appropriations requirement since full costs would be recovered from users. [Emphasis added.]

Consequently, the Working Capital Fund is required to collect from benefiting entities the full cost of services provided in order to continue operations without additional appropriations. The billing rates to benefiting entities are essentially made up of two components. The first component is made up of operational costs such as salaries, accrued annual leave, supplies, materials, and overhead. The billing rates for these charges are generally determined in advance and based on budgets and are to be adjusted periodically to ensure that customers are not overcharged or undercharged. Accordingly, any excess funds accumulating as a result of these charges would be offset in subsequent billing rates. The second component is made up of charges for depreciation expenses plus an additional amount to compensate for inflation to replace equipment and other capital assets. The funds resulting from these charges are set aside in reserve for equipment replacement and other planned capital improvements and changes. The funds accumulated in this reserve that are in excess of the planned capital reinvestment purposes are to be identified as surplus and returned to the U.S. Treasury.

The legislation establishing the Working Capital Fund provides that the Fund will be available for expenses such as acquisition, replacement, and operation of a central computer and related automated data processing equipment; engineering services; payroll and other management services; and acquisition and replacement of equipment and facilities. The Working Capital Fund is currently composed of 27 activities (see Appendix 2), which provide regional or Bureauwide services such as finance, accounting, cost recovery, technical support, and equipment. Other activities can be added or existing activities can be expanded as needed to provide services in support of the Bureau's mission.

The management and administration of the Working Capital Fund were transferred in July 1994 from the Bureau's Division of Program Coordination and Budget to the Denver Service Center's Management Services Office, which is responsible for establishing the policies and procedures necessary to ensure effective operation of the Fund.

SCOPE OF AUDIT

Our audit included a review and analysis of financial statements and reports, budgets, cost recovery rate calculation work sheets, and accounting records pertaining to the Working Capital Fund for fiscal years 1993 through 1995. We also reviewed documentation for fiscal years prior to 1993 to compare Working Capital Fund budgeted costs with actual costs to determine how overrecoveries or underrecoveries of capital reserves occurred.

Our audit was made in accordance with the "Government Auditing Standards," issued by the Comptroller General of the United States. Accordingly, we included such tests of records and other auditing procedures that were considered necessary under the circumstances. The audit was conducted at the Bureau's Management Services Office and Administrative Service Center in Denver, Colorado, and we contacted the Bureau's regional offices to obtain documentation and information regarding specific Working Capital Fund activities. We also reviewed the operating policies and procedures of the Department of Justice's Working Capital Fund and the U.S. Army Corps of Engineers Revolving Fund, and we discussed Bureau procedures regarding cost recovery with officials from the Office of Management and Budget.

In addition, we reviewed the Secretary's Annual Statement and Report to the President and the Congress for fiscal year 1994, required by the Federal Managers' Financial Integrity Act of 1982, to determine whether any reported weaknesses were within the objective and scope of our audit. We determined that none of the reported weaknesses were directly related to the objective and scope of our audit.

PRIOR AUDIT COVERAGE

Neither the Office of Inspector General nor the General Accounting Office has issued any audit reports on the Bureau's Working Capital Fund. However, the Office of Inspector General has issued two audit reports within the past 5 years on components of the Working Capital Fund as follows:

- Our June 1994 report "Operation of the Federal Financial System, Denver Administrative Service Center, Bureau of Reclamation" (No. 94-1-609) stated that users of the Federal Financial System were not being provided specific information on the costs of the services provided. We found that the Administrative Service Center had implemented a System Resource Units method to provide its users with information on costs and system utilization.

- Our October 1994 report "Accounting for Fiscal Year 1993 Reimbursable Expenditures of Environmental Protection Agency Superfund Money, Bureau of Reclamation" (No. 94-1-1312) stated that the Bureau should reimburse the Working Capital Fund for the unallowable expenditures in the indirect cost pool and recalculate the year-end overrecoveries or underrecoveries. The report also stated that Bureau management should review, analyze, and recommend improvements to all rate-setting and cost-allocation procedures to ensure the integrity of the Working Capital Fund. The Bureau did not agree with the first recommendation. However, in a subsequent memorandum from the Assistant Secretary for Water and Science to the Office of Inspector General, the Assistant Secretary agreed that unallowable expenditures should not be charged to the Working Capital Fund. Consequently, the Bureau's Finance and Accounting Services issued a directive to all regional coordinators of the Working Capital Fund that reiterated the requirements to review rates and expenses transferred through cost allocation to ensure that the expenses are properly charged to customers.

RESULTS OF AUDIT

Based on our audit, we concluded that: (1) the Bureau had not fully complied with the legislation establishing the Working Capital Fund; (2) the Fund was not being operated effectively and fully recovering its costs; and (3) the Fund's internal control structure provided reasonable assurance that transactions were recorded properly, except for the internal control weaknesses related to the conditions noted and as discussed below.

The legislation that established the Fund requires the Bureau to recover the cost of operations, including depreciation and accrued annual leave, and to return any surplus funds derived from accumulated depreciation charges to the U.S. Treasury. However, the Bureau did not comply with this requirement in that it did not adequately monitor and enforce cost recovery. Instead, individual activity managers developed their own methodologies for establishing billing rates and for using funds. As a result, depreciation costs of $25.3 million were not recovered; accrued annual leave of $9.7 million was not funded; and customers were overcharged $15.6 million for operational expenses. In addition, the Bureau was using funds derived from the overcharges to subsidize non-Fund-related activities. Furthermore, the Bureau had not established a multiyear capital reinvestment plan to support the need for the Fund's reported capital reserve of $69.3 million. Therefore, it was not possible to determine whether any portion of the capital reserve should have been returned to the Treasury, as required by law.

Recovery of Depreciation Expenses

We found that activity managers were not consistent in setting billing rates, which resulted in certain activities not recovering their full cost of the capital investment. Specifically, some activities did not include or included only a portion of their depreciation expenses in their billing rates. As a result, we estimated that as of September 30, 1994, the Fund had not recovered $25.3 million of depreciation expenses. The activities with the most significant underrecoveries were the Administrative Service Center, Computer Aided Design and Drafting, and Drilling Operations.

Inconsistencies in recovering capital investment costs occurred because the Bureau had not enforced its policy regarding full cost recovery. Consequently, each activity established its own policy as the policy benefited the needs of the individual activity. For example, Administrative Service Center officials stated that the Center did not fully charge for depreciation because, in their opinion, it did not need to recover its original capital investment for future use, since the cost of computer equipment was decreasing and its customers would not agree to the higher rates that would result from including depreciation costs.

Drilling Operations did not include the full amount of depreciation expenses in its billing rates. Specifically, 91 percent of its $2.7 million underrecovery of capital

investment as of September 30, 1994, was accounted for by the following regions: the Pacific Northwest Region - $664,000; the Lower Colorado Region - $945,000; and the Great Plains Region - $857,000. Regional Drilling Operations managers said that they had “unilaterally” decided not to include the full cost of depreciation in their cost recovery rates because they did not need to recover the full amount of the Drilling Operations capital investment and because the regions wanted to keep the rates charged to their customers “competitive.” In addition, Drilling Operations had used its capital reserves to subsidize its operations and maintenance costs in attempts to keep its rates low. As a result of these actions, additional funding will be needed to continue activities of Drilling Operations unless cost controls are initiated, rates are increased, or services are discontinued.

The legislation that established the Fund requires full cost recovery, including depreciation, and the Bureau’s policy also requires the recovery of depreciation. Accordingly, the Bureau should require each activity to fully recover its depreciation expense regardless of individual activity needs for the resultant accumulated funds.

Management of Capital Reserves

The Bureau had not developed a budgetary process to determine whether the Fund’s Capital Reserves were needed for replacement of equipment and enhancement of Fund activities or whether they were surplus and should have been returned to the Treasury, as required by law. The legislation establishing the Fund states, “Funds that are not necessary to carry out the activities to be financed by the fund, as determined by the Secretary, shall be covered into miscellaneous receipts of the Treasury.” We found that the Bureau did not have adequate budgetary controls, such as a multiyear capital reinvestment plan, that would detail and compare individual activity reinvestment requirements and overall Fund reinvestment requirements to available funds. For example, the Working Capital Fund’s Management Services Office did not approve individual activity fund capital reinvestment plans and did not incorporate all activity plans into an integrated overall Fund reinvestment plan. As a result, we could not determine whether any portion of the reported $69.3 million of Capital Reserves was surplus to verifiable needs and, as such, should have been returned to the Treasury.

Consequently, the Bureau needs to develop budgetary procedures for its Capital Reserves in order to meet the overall reinvestment needs of the Fund and to determine whether funds are surplus. Specifically, each activity should prepare a multiyear capital reinvestment plan that details the capital reinvestment requirements of the particular activity as compared with activity funds available. Approval of individual activity fund plans should be contingent on the incorporation of all plans into an integrated overall Fund reinvestment plan that would prioritize all reinvestment needs. Any reserves not needed to meet the purposes of the overall plan should be declared surplus and returned to the Treasury.

Funding Accrued Annual Leave

The Bureau did not include the costs of accrued annual leave in the billing rates for Fund activities because, according to Fund managers, administration of funded accrued annual leave would be "difficult" and the current method of funding the costs of current year leave is sufficient. Currently, annual leave is funded when the leave is taken instead of when it is earned. However, legislation establishing the Fund requires cost recovery, and this would require that the annual leave be funded when it is earned or accrued. Because the costs of accrued annual leave were not included in the billing rates, the Fund reported $7.8 million of accrued annual leave as unfunded at September 30, 1994. This balance had increased by $1.9 million, to $9.7 million, as of August 31, 1995. Three activities accounted for $8.5 million, or 87 percent, of the $9.7 million balance. These activities were the Indirect Cost Recovery activity -$3.7 million; the Administrative Service Center -$1.3 million; and the Technical Service Center - $3.5 million. In our opinion, because the Fund is intended to operate within its own resources, unlike Government-appropriated activities, the costs of the annual leave should be included in the billing rates when the leave is earned instead of when it is taken.

Overrecovery of Operational Costs

Some Fund activities were not adjusting their billing rates to compensate for the overrecovery of costs. The activities based their billing rates on budgeted amounts. However, when actual costs became known, subsequent rates were not adjusted to reflect the difference between budgeted and actual amounts. For example, the Bureau did not adjust the fiscal year 1995 billing rates for 1994 overrecoveries that totaled approximately $15.6 million. The Indirect Cost Recovery activity accounted for $6.2 million of the total overrecovery.

The overrecovery occurred because the regions did not have adequate budget information available to develop their indirect cost rates, did not adequately monitor the indirect cost rates to ensure that revenues equaled expenses, and did not adjust indirect cost rates by year-end overrecoveries and underrecoveries. For example, the Mid-Pacific Region could not provide us with the budget information to support its indirect cost rate without having to reconstruct it and could not provide us with budget information to support its area offices' indirect cost rates. The Lower Colorado Region's indirect cost budget did not provide a breakdown of budgeted cost components so that budgeted and actual costs by object class category could be compared. This basic budgetary information was necessary for the Bureau to monitor the indirect cost rates on a periodic basis to prevent overrecoveries or underrecoveries. Because there was no comparison of budgeted and actual costs, activity managers were able to maintain the indirect cost overrecoveries as a reserve to be used as a "cushion" or as a source of funding.

The regional offices said that revenues for the Indirect Cost Recovery activity, recovered through an indirect cost charge, were monitored on a monthly basis and

that indirect cost rates were adjusted to ensure that revenues approximated costs. However, our testing disclosed that the Indirect Cost Recovery activity was not adequately monitored and that overrecoveries were not used to reduce billing rates.

The conditions regarding indirect cost controls, budgets, and overrecoveries and underrecoveries are long-standing. For example, the Bureau's 1991 update to the 1989 report "Total Cost of Doing Business Report" stated to Bureau management that there were no cost standards or consistencies in the types of costs treated as indirect; there was a lack of budget information for developing indirect cost rates; indirect accounts were used as a "convenient means" of distributing costs rather than costs being distributed based on benefit or equity; indirect costs were considered by many as a source of funding; "arbitrary assessments" were made to indirect accounts for the purpose of building reserves or to offset expenses of unrelated activities; and indirect cost rates were overstated. The 1991 update recommended the establishment of "budgets and controls for Reclamation's indirect costs accounts." The team that developed the report considered this recommendation as one of the highest priorities assigned for implementation. However, we found that the Bureau had not taken all the corrective actions needed to resolve the recommendation. We agree that the Bureau should issue and enforce standardized procedures regarding the establishment and adjustment of these cost recovery rates.

Overrecoveries Used to Subsidize Other Activities

Surplus funds generated by overcharges to customers were used to fund other activities, including activities occurring outside the Fund. For example, in fiscal year 1994, the Pacific Northwest Region provided the overrecovery of its Indirect Cost Recovery activity to the Office of the Secretary's Office of Aircraft Services to purchase a $1.1 million aircraft. The Region submitted an Office of Management and Budget Circular A-76 ("Performance of Commercial Activities") review to the Department and received approval from the Department to purchase the aircraft. However, in our opinion, the Region's procedure for the purchase was inadequate because the use of surplus funds from the Indirect Cost Recovery activity removed the purchase from the budgetary review process of the Office of Management and Budget and the Congress. Also, the source of funds used to purchase the aircraft was inconsistent with the Fund's requirements and the overall purpose of the Fund. Specifically, a capital asset was acquired using operational cost overrecoveries instead of capital reserves. In addition, the aircraft, which is being leased from the Office of Aircraft Services, is not being used in support of the Fund's activities that provided the funding used to purchase it.

Management Actions

The Management Services Office has begun to take action to correct some of the long-standing deficiencies affecting the Fund. Specifically, Services Office officials have revised the "Working Capital Fund Guidebook," which provides Fund policies and procedures to address the accounting for revenues, equipment purchases, and

capital reserves; budgeting; and the preparation of financial reports. The guidebook addresses procedures for accounting for inter-Fund loans and repayments, capitalizing software development, transferring capital assets, and setting rates for Fund activities. Services Office officials issued the draft guidebook in November 1995 and plan to issue the final guidebook by September 30, 1996. During fiscal year 1995, the Services Office initiated procedures that were incorporated into the revised guidebook, such as requiring the regions to submit budgets to the Services Office.

We do not believe that the changes to the guidebook, particularly those pertaining to the preparation, submission, and review of activity budgets, will correct the deficiencies noted. Specifically, in our opinion, the contemplated budgetary review process is insufficient to ensure adequate control over the Fund's Capital Reserves. We believe that Fund management needs to provide more direct control by reviewing and approving the methods used to recover costs, set billing rates, prepare budgets, and plan capital reinvestment of the various activity funds to ensure that the overall goals of the Fund are accomplished, including the identification of any surplus funds and their subsequent return to the Treasury.

Recommendations

We recommend that the Commissioner, Bureau of Reclamation:

1. Require that Working Capital Fund activities establish billing rates that will recover full costs, including depreciation and accrued annual leave.

2. Require individual activities of the Working Capital Fund to prepare and approve multiyear capital investment plans. In addition, an overall Working Capital Fund multiyear capital investment plan should be prepared that integrates and prioritizes the investment needs of both the various activities and the overall Working Capital Fund.

3. Revise Working Capital Fund procedures to ensure that an accurate and supportable determination can be made as to when the Fund has a surplus and to ensure that the surplus funds from the reserves are returned to the Treasury.

4. Require the Management Services Office to monitor the financial performance of the various activities to control and ensure compliance with the requirements regarding cost recovery, capital investment plans, rate setting, and use of funds that are overrecovered.

5. Revise the policies and procedures for management of the Fund's indirect costs to ensure the following:

- That regions prepare and submit indirect cost budgets for each indirect cost rate.

- That regions periodically, and not less than annually, monitor indirect cost revenues and expenditures to ensure that the Indirect Cost Recovery activity does not have a surplus or a deficit and records no more than a nominal overrecovery or underrecovery at fiscal year-end.

- That regions annually adjust billing rates by the amounts of the prior overrecoveries and underrecoveries.

- That regional directors review regional indirect cost accounts to ensure that the regions are not maintaining reserves.

- That regions are aware that the overrecoveries should not be used for unbudgeted expenses or to subsidize other activities.

- That regions include only costs in the Indirect Cost Recovery activity that are administrative and overhead in nature, that are not incurred in support of specific activities, and that cannot practically be identified and charged to specific activities.

6. Require the applicable activities of the Fund to return to their customers, through reduced future billings, the $15.6 million overrecovery.

7. Require that the funds which were transferred to the Office of Aircraft Services, Office of the Secretary, be taken from the Capital Reserves account.

Bureau of Reclamation Response and Office of Inspector General Reply

In its March 7, 1996, response (Appendix 3) to the draft report, the Bureau of Reclamation concurred with Recommendations 1, 2, 3, 4, and 5 and did not concur with Recommendations 6 and 7. Based on the response, Recommendations 2, 3, 4, and 5 are considered resolved but not implemented. Accordingly, the resolved but unimplemented recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation. Even though the Bureau concurred with Recommendation 1, this recommendation is considered unresolved because of the extent to which the Bureau qualified its concurrence. Therefore, the Bureau is requested to reconsider its response to Recommendation 1 and to Recommendations 6 and 7, which are also unresolved (see Appendix 4).

Recommendation 1. Concurrence.

Bureau Response. The Bureau stated that it will issue its revised Fund Guidebook "that will require full cost recovery, including depreciation and accrued annual leave through the billing rates." The Bureau further stated that "as long as the decision is properly documented," the full recovery of depreciation can be foregone when warranted by "economic conditions or technological obsolescence."

Office of Inspector Reply. We are not aware of any provision in the Fund legislation that allows for management discretion regarding full cost recovery. Accordingly, without a Solicitor's opinion or other statutory authority to support the Bureau's position that it can ''exercise management discretion" with regard to not recovering full costs, reconsider the recommendation unresolved and request that the Bureau reconsider its response.

Recommendation. Nonconcurrence.

Bureau Response. The Bureau disagreed with the recommendation, stating that it "does not subscribe to the two-component principle" presented in our report or to the related computations of overrecoveries and underrecoveries. The Bureau further stated, "In cases where overcharges of all activity costs were made--regardless of component breakout--and where there is no planned use for these funds to benefit the customers from which they were obtained, the activity manager will refund these excesses through reduced rates."

Office of Inspector General Reply. Regardless of whether or not it subscribes to the two-component principle, the Bureau must set the prices for its goods and services to recover both capital and operating costs (two-component principle). With regard to capital costs, the Bureau's annual Fund budget justifications for fiscal years 1988 through 1991 established a clear distinction between operating and capital costs. Specifically, the Bureau's budget justifications stated, "The fund will accumulate funds from charges for depreciation to be used for replacement of assets." In our opinion, the budget justifications clearly indicate that funds (capital reserves) will be accumulated from depreciation charges and, as such, that the depreciation component must be readily identifiable. Also, since the legislation establishing the Fund requires that funds (derived from depreciation charges) not necessary to carry out the activities of the Fund be returned to the Treasury, the Bureau must use the two-component principle to readily separate the operating charges from depreciation charges that might become available to be returned to the Treasury.

With regard to operating costs, the Fund legislation states, "Charges to users will be at rates approximately equal to the costs." As such, operational costs included in billing rates should approximate actual costs and be adjusted to ensure that customers are not overcharged or undercharged. The legislation does not provide for a "profit" for the Bureau to use at its discretion. In addition, the Energy and Water Development Appropriation Bill of 1986 states, "The Committee recommends bill language, . . . to establish a Working Capital Fund . . . This is similar to the revolving fund of the Corps of Engineers." We compared the Bureau's Fund procedures with those of the Army Corps of Engineers and found that the Corps Revolving Fund clearly distinguishes between operating and capital costs.

We also believe that the Bureau, in wanting to use overcharges for operating costs for whatever purpose it deems necessary, will permit the continuation of "cushions." We do not believe that this policy is in keeping with either the enabling legislation

or the overall purpose of the Fund. Accordingly, we request that the Bureau reconsider its response to the recommendation.

Recommendation 7. Nonconcurrence.

Bureau Response. The Bureau disagreed with the recommendation, stating that it does not maintain "unique activity accounts to distinguish between capital equipment used for indirect purposes and other indirect costs incurred." The Bureau further stated that "little would be accomplished by refunding money to these customers only to turn around and ask them to fund the airplane purchase."

Office of Inspector General Reply. We concluded that the accounting treatment used by the Fund for the purchase of the airplane was inconsistent with Fund accounting principles and the overall purpose of the Fund. Specifically, a capital asset was acquired using operational cost overrecoveries instead of capital reserves. Accordingly, implementation of our recommendation will provide for proper accounting treatment and adjustment to the capital reserve account. Once the Bureau recognizes the two-component principle for recovering capital and operating costs, the recommendation can be implemented by an accounting entry to transfer the airplane purchase costs from the operating costs surplus to the capital reserve surplus. Thus, the Bureau will not have to recover the funds from its customers "only to turn around and ask them to fund the airplane purchase." Therefore, we request that the Bureau reconsider its response to this recommendation.

Additional Comments

Bureau Response. The Bureau disagreed with our conclusion that it had not fully complied with Working Capital Fund legislation, that it had internal control weaknesses pertaining to adequately monitoring and enforcing cost recovery, and that it had not developed budgetary procedures to determine whether the Fund's capital reserves were needed or whether they were surplus and should have been returned to the Treasury. The Bureau also disagreed with our computation of lost revenues. The Bureau stated that it is not convinced that the $9.7 million historical balance for accrued leave cited in the report is the full responsibility of the Fund because many employees with significant leave balances transferred into the Fund from other appropriated activities and thus only a portion of the historical accrued leave balance will have to be funded by customers of the Fund.

Office of Inspector General Reply. Regarding compliance with Working Capital Fund legislation, our report stated that the Bureau had not complied with the legislation because it did not have adequate controls to ensure that costs were fully recovered and that it had not developed budgetary control procedures to determine whether capital reserve funds were surplus to verifiable needs. Specifically, we found that the Bureau relied primarily on its Fund activity managers to carry out policy and ensure compliance. However, we believe that our report supports the conclusion

that this strategy did not succeed because of a lack of sufficient controls and oversight.

We believe that the Bureau's position to allow its Fund activity managers to set and implement policies is clearly contrary to legislative requirements and Working Capital Fund polices. We agree that Fund management must have the ability to control the billing activities of its various activity funds. However, management must also ensure compliance with the cost recovery requirements. Furthermore, the Bureau, in order to identify any surplus funds, should be able to identify, at any time, what its capital reserves are and what they should be and to what purposes those funds are going to be applied.

The $35 million of lost revenues represents $25.3 million for the underrecovery of depreciation expenses and $9.7 million for accrued annual leave that the Bureau had not included in its billing rates to its customers. The $25.3 million underrecovery is based on methodology provided by the Bureau's prior Working Capital Fund Coordinator, which we reviewed, tested, and determined to be a sound basis for computing overrecoveries and underrecoveries. Although the Bureau's Management Services Office did not agree with this methodology, the Services Office had not developed an alternative methodology. The $9.7 million of accrued annual leave is based on amounts from the Bureau's general ledgers. We disagree with the Bureau's suggestion that the $35 million of undercharges identified in our report as lost revenues should be offset by the $15.6 million identified in our report as overcharges. Under the two-component principle, the undercharges were made in the capital costs component, while the overcharges were made in the operating costs component. Since these two components must remain separate and distinct, an overrecovery in one component cannot be used to offset an underrecovery in the other component.

With regard to the Bureau's statement that it is responsible for only a portion of the historical accrued leave balance because employees with significant leave balances transferred into the Fund from other appropriated activities, we agree. However, it should be noted that we obtained the $9.7 million for accrued annual leave from the Fund's financial statements, where it is recognized as a liability. If the Bureau believes that the Fund is not responsible for the entire $9.7 million historical amount, it should take appropriate action to determine the amount for which the Fund is liable and make the appropriate adjustment to the Fund's financial statements.

In accordance with the Departmental Manual (360DM 5.3), we are requesting a written response to the report by June 28, 1996. The response should provide the information requested in Appendix 4.

The legislation, as amended, creating the Office of Inspector General requires semiannual reporting to the Congress on all audit reports issued, the monetary impact of audit findings (Appendix 1), actions taken to implement audit recommendations, and identification of each significant recommendation on which corrective action has not been taken.

CLASSIFICATION OF MONETARY AMOUNTS

Finding Area	Lost Revenues (In millions)
Underrecovery of Depreciation Expenses	$25.3
Accrued Annual Leave	9.7
Total	$35.0

BUREAU OF RECLAMATION
WORKING CAPITAL FUND ACTIVITIES

ACTIVITY	FUND CODE	ACTIVITY DESCRIPTION	FY 1995 BUDGET
Central Computer Site	K10	Provides for the management, operation, and maintenance of central computer capability for all Bureau activities.	$900,000
Indirect Costs	K12	Provides for indirect or overhead costs that cannot be directly charged to a project or beneficiary. Costs are charged through an indirect cost recovery rate applied to each dollar of direct labor. Indirect cost rates are established for each office.	111,235,000
Minicomputer Systems Fund	K13	Provides minicomputer systems for central computer capability to each of the regional offices, as well as Bureauwide.	3,774,000
Transportation Vehicles	K14	Provides transportation of vehicles for use by the Denver Office, regional offices, or project personnel.	1,004,000
Capitalized Movable Property	K15	Provides for all movable capitalized property benefiting more than one project, but excludes property specifically accounted for in other Working Capital Fund activities.	250,000
Comprehensive Construction Training Program	K16	Provides construction training for construction inspectors both in the Bureau and other entities.	10,000
Aircraft Operations	K17	Provides for operation and maintenance costs of aircraft used by regional personnel.	1,828,000
Drilling Operations	K18	Provides for costs of drill crews and their drilling equipment that are billed to projects.	5,644.000
Centralized Finance	K19	Provides Bureauwide financial management and accounting services, including finance policy, systems support, fund control, and cost accounting.	6,500,000
Soil and Water Quality Laboratories	K21	Provides for centralized soil and water quality analysis facilities for projects and studies in the regional offices.	1,633,000
Data Communications	K22	Provides for management of Bureauwide data communications network, including installation and maintenance of data communication services used primarily for accessing information resource systems.	3.712,000
Computer Aided Design and Drafting	K23	Provides hardware, software, and technical personnel for Bureauwide computer-aided design capabilities and communications.	4,000,000

ACTIVITY	FUND CODE	ACTIVITY DESCRIPTION	FY 1995 BUDGET
Cooperative Administrative Support Unit(CASU)-Mid-Pacific Region	K24	Provides administrative services for the Department and other agencies in the Sacramento area.	155,000
Denver Office Research and Lab Service	K25	Provides laboratory services for chemistry, concrete testing, soils testing, synthetic materials testing, and hydraulics testing.	o
Engineering Workstation Operations and Maintenance	K26	Provides decision support and advanced computer technology for integrated analysis and graphical display of technical problems in water and power.	970,000
Geographic Information System	K27	Provides Geographic Information System hardware and software designed to collect, manage, and analyze spatially-referenced data.	600,000
Hydrographic Survey Equipment	K28	Provides hydrographic surveys of Bureau reservoirs and rivers to define water storage space available for reservoir management.	30,000
Personal Computer Lab	K29	Provides for financial management of the Denver Office PC Lab function.	1,200,000
Training Aid for Dam Safety	K30	Provides self-instructional training program in various aspects of dam safety.	30,000
ADP Software Applications	K31	Provides funding for development and maintenance of approved Bureauwide software applications and information systems.	6,800,000
ADP Capital Investment	K33	Provides central management of Bureauwide capital investments. Also provides centralized source of financing for major information resources.	2.609.000
Bend, Oregon, Construction Office	K35	Provides for distribution of administrative costs for the Bend, Oregon, Construction Office, which services various construction and operation and maintenance projects and other Governmental agencies.	93,000
Pacific Northwest Regional Activity	K36	Provides for the operation, maintenance, and cost recovery of the Accessibility Data Management System (ADMS). ADMS is a Governmentwide data base for evaluating and tracking the accessibility, mandated by the Rehabilitation Act of 1973, of Government programs, policies, and facilities.	463,000

ACTIVITY	FUND CODE	ACTIVITY DESCRIPTION	FY 1995 BUDGET
Administrative Service Center	K41	Provides services, including computer operations, the Federal Financial System, the Payroll/Personnel System, and the Federal Personnel Payroll Program, to customers within the Department of the Interior, including the Bureau, and to customers outside the Department.	31,928,000
Denver Office Common Supply Activities	K47	Provides for common services such as personnel and facilities management to Denver Office organizations.	7,225,000
Technological Service Center	K88	Provides engineering and technical support to the Bureau's regional and project offices.	69,423,000
Leave Account	K90	Provides for funding of costs of actual leave taken. This fund is credited with a leave additive, which is charged to employees' salaries and expensed when employees take leave.	52,725,000
		TOTAL FY 1995 BUDGET	$314,741,000

United States Department of the Interior

BUREAU OF RECLAMATION
WASHINGTON, D.C. 20240

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MEMORANDUM

To: Office of Inspector General
Attention: Acting Assistant Inspector General for Audits

From: FOR Eluid L. Martinez
Commissioner

Subject: Response to Draft Audit Report on Working Capital Fund, Bureau of Reclamation (Report No. C-IN-BOR-002-95)

The Bureau of Reclamation appreciates the opportunity to comment on the subject report. We are concerned, however, with some aspects of the report that suggest Reclamation is not taking adequate steps to improve its Working Capital Fund (Fund) business practices.

Reclamation recognized in its 1989 internal "Total Cost of Business" report the need for more accurate accounting of indirect costs. In 1992, we issued an internal management control report in which we documented Fund-related problems and recommended corrective actions. Since that time, significant progress has been made, including the assignment of the Fund's administration to the Management Services Office in Denver, and the issuance of improved policy guidance with the revision of the Fund's guidebook in 1993. In 1995, before the audit was announced, Reclamation began to take even more aggressive steps in establishing greater organizational control over, and introducing more sound business practices to the Fund. We believe these actions will ensure the Fund's continued viability into the future and establish confidence that we are complying with all aspects of the law.

The audit report draws a clear distinction between recovering operating and capital costs. We agree that all costs should be recovered but find no clear guidance that requires recovery be by component. Some of the Fund activities are a hybrid mixture of capital and operating services (e.g., the Administrative Service Center (ASC)). We believe that as long as the total costs of providing the service for each activity are fully recovered, individual cost components notwithstanding (i.e., equipment, labor, printing, etc.), the objective and legislative direction of the Fund has been satisfied. With this in mind, we believe the over-recovery and under-recovery amounts detailed

in the report distort the true financial position of the activities in question. For example, activities such as the ASC are not only financially solvent but have adequate fund reserves for capital replacement. Moreover, we question the report's finding that there was $35 million in "lost revenue." When offset by the $15.6 million of supposed "overcharges" identified in the report, the characterization of the $35 million amount as "lost revenues" appears to be misleading. In fact, as detailed below, we not only question the validity of these amounts, but have fundamental differences as to what they represent.

The audit report also states that Reclamation has not complied with the legislative requirement of the Fund to return any surpluses back to the Treasury. We agree that unneeded Fund surpluses must be returned to the Treasury. The Fund was established to provide Reclamation-wide flexibility to fund service-type capital purchases and activities in support of Reclamation's mission. When Reclamation proposed the language authorizing the Fund, we intended, and believe the legislation supports, that the Fund as a whole is the ongoing economic entity upon which we must assess whether a surplus exists. We do not believe that the viability of unique activities, which were established as an administrative convenience within the Fund, should be the test of whether a surplus exists for return to the Treasury. We believe that when one activity ceases to exist or provide benefit, its reserve or unobligated balance becomes available for Reclamation to use within the Fund for some other authorized purpose--once again, to fulfill the objective of utilizing cost effective business practices to accomplish Reclamation's mission.

Since the Fund's inception, Reclamation has been aware of its reserve balance and made plans for its appropriate use, whether to replace Fund equipment or pursue a legitimate Fund activity. It is Reclamation's position that there has not been any surplus available to return to the Treasury (including any portion of the $69.3 million unobligated reserve as of 1994). In this matter, we believe we have fully complied with the requirements of the legislation.

The report goes on to identify under-recovery of depreciation as an internal control issue. We do not agree that this is an internal control issue as much as it is a matter of management policy. Management discretion is a key factor in making capital investment decisions based on changing business conditions that result from improved efficiencies, technological advances, economies-of-scale, and changing economic or market conditions which, in some cases, may be driven by legislative mandate. For example, technological advances in the computer and computer-related areas continue to provide improved productivity, while sometimes rendering existing equipment technologically obsolete before exhausting its useful life. Also, mandated downsizing, cuts in Federal programs, and a shrinking customer base require Reclamation to continuously monitor and evaluate the viability of the services it provides. Investment write-offs are a necessary outcome of either situation, without which the existing customers would be unduly penalized. We maintain that in these instances,

Reclamation must have the ability to exercise management discretion, provided accountability is well documented, to forego equipment (or software development) recovery even when doing so may result in temporary losses.

We note that the report also indicates that Reclamation must recover all accrued annual leave associated with the Fund, including the August 1995 balance of $9.7 million. Reclamation agrees that current year accrued leave costs in the Fund must be recovered. We are not convinced, however, that the $9.7 million historical balance cited in the report is the full responsibility of the Fund. We note that the organic act permits transfers into the Fund “less any liabilities. ” Because many employees with significant leave balances transferred into the Fund from other appropriated activities, we believe only a portion of the historical accrued leave balance will have to be funded by the customers of the Fund.

Reclamation offers the following comments in response to the recommendations on the subject audit report.

We recommend that the Commissioner, Bureau of Reclamation:

Recommendation 1

Require that Working Capital Fund activities establish billing rates that will recover full costs, including depreciation and accrued annual leave.

> Response: Concur. Reclamation will issue its revised Fund Guidebook that will require full cost recovery, including depreciation and accrued annual leave through the billing rates. We believe management also reserves the right, so long as the decision is properly documented, to forego the full recovery of depreciation when economic conditions or technological obsolescence warrant such action.
>
> The responsible official is the Leader, Finance and Accounting Services. The target date for issuing the revised Fund Guidebook is September 30, 1996.

Recommendation 2

Require individual activities of the Working Capital Fund to prepare and approve multi-year capital investment plans. In addition, an overall Working Capital Fund multi-year capital investment plan should be prepared that integrates and prioritizes the investment needs of both the various activities and the overall Working Capital Fund.

Response: Concur. Since the Fund's inception, planned capital equipment purchases have been identified in annual budget submissions to Reclamation's Washington Office. Plans will be provided and summarized consistent with the Fund's customer base.

The responsible officials for preparing multi-year capital investment plans are the Fund activity managers, while the responsible official for summarizing the Reclamation-wide data is the Leader, Finance and Accounting Services. The target date for summarizing capital investment plans is September 30, 1996.

Recommendation 3

Revise Working Capital Fund procedures to ensure that an accurate and supportable determination can be made as to when the Fund has a surplus and to ensure that the surplus funds from the reserves are returned to the Treasury.

Response: Concur. This will be accomplished through the revised Fund Guidebook.

The responsible official is the Leader, Finance and Accounting Services . The target date for issuing the revised Fund Guidebook is September 30, 1996.

Recommendation 4

Require the Management Services Office to monitor the financial performance of the various activities to control and ensure compliance with the requirements regarding cost recovery, capital investment plans, rate setting, and the use of funds that are over-recovered.

Response: Complied. The Management Services Office will monitor activities and performance of the Fund, as well as exchange information with Fund activity managers, to enable them to assert necessary controls over local activities and ensure compliance with Reclamation-wide Fund policies. Reclamation believes that the revised Fund Guidebook with its reporting and documentation requirements, a more engaged central management of the Fund, and an improved understanding of both the operational and management requirements of the activities will implement the objective of this recommendation.

Recommendation 5

Revise the policies and procedures for management of the Fund's indirect costs to ensure the following:

- That regions prepare and submit indirect cost budgets for each indirect cost rate.

- That regions periodically, and not less than annually, monitor indirect cost revenues and expenditures to ensure that the Indirect Cost Recovery activity does not have a surplus or a deficit and records no more than a nominal over-recovery or under-recovery at fiscal year-end.

- That regions annually adjust billing rates by the amounts of the prior over-recoveries and under-recoveries.

- That regional directors review regional indirect costs accounts to ensure that the regions are not maintaining reserves.

- That regions are aware that over-recoveries should not be used for unbudgeted expenses or to subsidize other activities.

- That regions include only costs in the Indirect Cost Recovery activity that are administrative and overhead in nature, that are not incurred in support of specific activities. and cannot practically be identified and charged to specific activities.

Response: Concur. This will be accomplished through the revised Fund Guidebook.

The responsible official is the Leader, Finance and Accounting Services . The target date for issuing the revised Fund Guidebook is September 30, 1996.

Recommendation 6

Require the applicable activities of the Fund to return to their customers, through reduced future billings, the $15.6 million over-recovery.

Response: Non-concur. As indicated above, Reclamation does not subscribe to the two-component principle espoused in the audit report nor the related over- and under-recovery computations. In cases where overcharges of all activity costs were made--regardless of component breakout--and where there is no planned use for these funds to benefit the customers from which they were obtained, the activity manager will refund these excesses through reduced rates.

Recommendation 7

Require the funds that were transferred to the Office of Aircraft Services, Office of the Secretary, be taken from the Capital Reserves account.

> Response: Non-concur. Reclamation's Pacific Northwest Region does not maintain unique activity accounts to distinguish between capital equipment used for indirect purposes and other indirect costs incurred. The airplane purchase was made from depreciation reserves generated from other indirect equipment and refunds received from vendors who supply the indirect cost activity. This funding pool was not generated from intentional surcharge assessments. The decision to use these funds for the plane's acquisition was predicated on the customer base being the same as the indirect cost account customers, and that these customers benefit from the plane's use in the same proportion as customers of other indirect services in the region. Reclamation believes little would be accomplished by refunding money to these customers only to turn around and ask them to fund the airplane purchase.

We welcome the opportunity to discuss our response with you if necessary. If you have any questions or require additional information, please contact Luis Maez at (303) 236-3289, extension 245.

cc: Assistant Secretary - Water and Science, Attention: Margaret Carpenter
Office of Financial Management, Attention: Wayne Howard

STATUS OF AUDIT REPORT RECOMMENDATIONS

Finding/Recommendation Reference	Status	Action Required
2, 3, 4, and 5	Resolved; not implemented.	No further response to the Office of Inspector General is required. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.
1, 6, and 7	Unresolved.	Reconsider each recommendation, and provide action plans that include target dates and titles of officials responsible for implementation.

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